Institute

#06
June 2022

# CROSS ASSET
## Investment Strategy

CIO VIEWS

**Tech sell-off and bond temptation**

AMUNDI INSTITUTE

**A look under the surface of the first-quarter earnings season**

Confidence must be earned
Amundi
ASSET MANAGEMENT

# #06 - June 2022

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CIO VIEWS

# Tech sell-off and bond temptation

**Vincent MORTIER,**
*Group Chief Investment Officer*

**Matteo GERMANO,**
*Deputy Group Chief Investment Office*

The second quarter of the year is becoming increasingly painful for tech stocks, recalling memories of the 2000s tech bubble bursting. The repricing of a more aggressive Fed stance has been brutal, real yields rose – the rate on 10-year TIPS has turned positive for the first time since 2020 – and on the nominal yields front, the US 10-year Treasury yield temporarily reached the 3% threshold, falling close to 2.75% on economic growth concerns. Rates are now at a level that could call for a recalibration of asset allocations.

The key themes to follow to detect future market directions are:

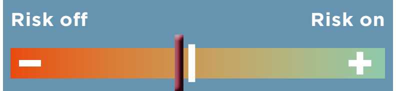
1. **Stagflationary risks:** The growth inflation battle is evolving unevenly at the global level, with the main theme being the shift from rising inflation and robust growth to lower growth and persistently high inflation. To account for this, our main scenario already pencils in regional divergences (technical recession for the Eurozone vs. US growth moving below potential, but no recession in 2022).
2. **China's economic outlook:** For 2022 we see growth at 3.5%, given the broad slowdown in economic activity since March, the extended lockdown in Shanghai and restrictions expanding into other regions. These will harm growth, particularly in Q2, while we expect a rebound in H2, thanks to more incisive policy support.
3. **Central banks:** In their fight against inflation and, most importantly, to preserve their credibility, central banks will continue to focus on communication while de facto staying behind the curve. In this battle, the ECB is facing more significant challenges than other CBs: the impact from the Russia-Ukraine conflict and from financial conditions tightening will be uneven across countries. High debt levels and higher economic risks on the euro periphery may impact the ECB's room for manoeuvre.
4. **Markets and earnings growth expectations:** We believe earnings expectations remain too optimistic across the board. We expect US EPS growth to be in the 5-9% range, supported by buybacks (consensus is at +9.8%) and for Europe to potentially enter a profit recession.

   All of this means that it is difficult to see an imminent end to the current weak market environment and, as such, while keeping an overall neutral risk stance, we believe some adjustments are warranted.

- **From a cross-asset perspective, we believe investors should further increase diversification while not increasing risk**. To achieve this, we have **become slightly more cautious on equity** – in particular regarding Europe, and while **we are more positive on US investment grade credit**, we maintain our relative preference for US equity amid the more resilient growth expectations for the US economy and higher earnings growth potential in the US equity market. We are **also positive on oil** for diversification purposes and as a hedge against the still-high geopolitical risk.
- **In bonds, we have further reduced our short duration stance** – in Europe in particular, but also in the US, and we believe **investors should move towards neutrality**. After the recent moves, the risks on nominal yields are now more symmetric, as on one side, inflation poses upward risks, while on the other, geopolitical and economic uncertainty favour downward moves. In credit, we continue to focus on quality and we are more cautious on higher-risk segments in Europe. We maintain our positive view on EM bonds in hard currency due to their attractive valuations and exposure to commodity exporters. Regarding currencies, we continue to hold a positive view on the US dollar vs. the euro.
- **Uncertainty regarding equities remains high as markets reprice the earnings path ahead**. Regionally, **we continue to favour the US vs. Europe while we remain neutral on EM.** While maintaining our preference for value, **we continue to increase the quality tilt**. In EM, we have become more cautious on Asia due to inflationary pressures and expensive valuations, while we remain positive on Brazil, UAE and Indonesia. In China, most of the bad news is priced in: an economic rebound, coupled with more benign regulation, should pave the way for a rebound in H2.

Although the 'great repricing' in equities and bonds may not be over yet, we are likely to see some pause and a continued rotation inside the market as it awaits more clarity on the inflation/growth outlook. In these uncertain times, investors should continue to focus on bottom-up selection as this will help in finding the most resilient names, but they should also look for opportunities that may have been excessively penalised during the repricing phase.

## Overall risk sentiment




**We have a slightly cautious risk stance and are increasing our cross-asset diversification. We continue to play the preference for US vs. Europe in equities.**

**Changes vs. previous month**

- Moving towards a neutral duration stance, with only a slightly short stance.
- More constructive on US IG credit, but cautious on higher risk credit
- Considering oil for diversification.

***Overall risk sentiment is a qualitative view of the overall risk assessment of the most recent global investment committee.***

AMUNDI INSTITUTE

# *Big* picture in *short*

**Pascal BLANQUÉ,**
*Chairman, Amundi Institute*

*Central Banks have had to hike rates and drain liquidity in this time of looming stagflation, but will maintain a benign-neglect tilt, and allow inflation to run to preserve growth*

## The end of the 'Great Coincidence' for the policy mix

The age of the 'Great Coincidence' in the policy mix is over. Budget deficit reductions are near, and will be accompanied by diminished household savings and greater pressure on corporate profits in light of wage negotiations. **The widespread belief that fiscal spending is effectively unlimited (i.e., the fiscal 'free lunch') is going to be severely tested. On the monetary side, we're witnessing the end of ultra-cheap money**. Central banks have had to hike rates and drain liquidity in this time of looming stagflation, but will maintain a benign-neglect tilt and allow inflation to run to preserve growth. While the public debate has been focused on the monetary side, we should look at the overall policy mix to understand the novel role of monetary policy. I see three possible scenarios moving forward:

1. **Continued fiscal expansion and monetary normalisation**. This is difficult, insofar as monetary normalisation is a fiscal space 'killer', making large debt burdens unsustainable. Moreover, policymakers should consider a safety net for further manoeuvring in case of recession. The main risk here is timing: monetary authorities could turn off the taps too quickly; and fiscal authorities could intervene too late. In markets, this option implies further repricing (towards the downside) on risky assets, particularly on interest-rate sensitive stocks.
2. **Central banks remain behind the curve for some time in order to accommodate a renewed fiscal impulse**. This is the best way to optimise the growth/inflation trade-off, and to engineer a controlled economic slowdown. Here, investors should look to combat inflation through dividend equity and real assets.
3. **Fiscal expansion and complete central bank accommodation, uprooting all inflation expectations, to levels most people today have never before been confronted with**. Think of this as a '70s style regime, with high inflation, nominal growth, market-led corrections in nominal rates, adjustments in all risk premia and valuations at equilibrium. Investors will have few places to hide except in cash and real assets.

While public opinion is mostly focused on the first option, I believe the second or third are more likely. **Fiscal spending must target critical new sets of public goods (the energy transition, social and strategic autonomy) and central banks will have to accommodate these priorities**. This is particularly true in Europe, where monetary authorities have to fill the void left by the lack of credible budgetary rules. The worst-case scenario is full-blown stagflation. If nothing is done on the fiscal side, then mechanically there will be a tightening in the policy mix, reversing the trend of the past few years.

**Didier BOROWSKI,**
*Head of Global Views*
*Amundi Institute*

## NATO expansion a watershed moment for geopolitical order

**Finland and Sweden have announced their intentions to join NATO, ending decades of neutrality/non-alignment. This is a tectonic shift, with major consequences for the regional geopolitical order.** Both countries immediately concluded that the Russian invasion of Ukraine could threaten their sovereignty. The Swedes and Finns are, however, careful to point out that their membership is defensive and primarily aimed at increasing their security. As evidence of this, Sweden is putting two conditions on its candidacy: no NATO base and no nuclear weapons on its territory.

Finland and Sweden are of strategic interest to NATO. Sweden's high-tech equipment enables intelligence gathering in the entire Baltic Sea region. Finland has nearly 900,000 reservists, who could provide a significant defence force for NATO. During the accession process, which could take a year, the two candidate countries are not protected by Article 5 of the NATO Treaty, which provides for mutual assistance by member states in case of aggression. That's why **the US and the UK have already stated that they would support both countries in the event of an attack in the interim.**

**President Erdogan threatens to veto their membership, probably because he wants to leverage the absence of a veto for some benefit.** In all likelihood, the Turkish president wants to secure the delivery of US military equipment to his country. Moreover, Erdogan is asking the two countries to abandon their support for the PKK rebels, who are hosted in their territories.

Russia called their membership applications to NATO a "serious mistake" with "far-reaching consequences". Russia has cut gas supplies to Finland, but has neither the means nor the desire to confront NATO. Retaliatory measures could, however, take many other forms (cyber-attacks, intimidation measures such as airspace violations, etc.).

**Our view: The invasion of Ukraine has affected the medium-term growth prospects of Sweden and Finland (uncertainty shock). Their accession will help restore the confidence of local economic actors and could encourage foreign investment. Furthermore, the application process should accelerate a reflection on the need to strengthen European defence.**

MULTI-ASSET

# Rotate risk allocation from equity to IG credit

**Francesco SANDRINI,**
*Head of Multi-Asset Strategies*

**John O'TOOLE,**
*Head of Multi-Asset Investment Solutions*

*Mounting concerns on the economic outlook call for a reallocation of risk from equity to quality credit, which looks more appealing after the recent repricing*

Mounting inflation concerns, along with geopolitical tensions, quantitative tightening (QT) and Covid restrictions in China are creating two main risks. One is related to the liquidity drain from QT and another to corporate margin compression, implying we should not ignore the risks of a profit recession, which is currently not priced in by the markets. On a positive note, consumption remains strong, labour markets tight and corporate balance sheets healthy, particularly in the US.

As a result, **investors should consider playing the relative resilience of the US, in particular adding into US IG credit, while becoming more cautious in cyclical equities, especially in Europe.** For diversification purposes, we continue to be positive on commodities and **we are now positive on oil**, where the tight supply will continue to support the bull market, despite the deceleration of demand due to the slowing economy.

## High conviction ideas

**We have a defensive stance in DM equities**, where we are cautious on Europe and play the relative preference for US equities against Europe. This reflects a desire to be less cyclically exposed in this phase of slowdown and avoid the areas most exposed to the effects of the Russia-Ukraine war. We are neutral in EM equities, but we acknowledge the impact of Covid restrictions on Chinese growth, and remain vigilant there.

**On duration, we maintain a slightly cautious stance in the US,** while globally we continue to explore opportunities at cross-country and curve levels. In Europe, we maintain our relative preference for Italy vs. Germany in the 10-year maturity, while we have closed our positive stance on France vs. Germany as the political risk premium faded after the elections. We believe in the steepening of the UK 2-10-year curve, as the BoE has displayed slightly dovish tendencies in light of the deteriorating outlook. 2Y yields currently price in aggressive tightening, but could move lower. The 10y yield should rise on the back of QT.

We have removed our positive bias for the Australia 10Y vs. the UK, as the surprising rate hike by the Reserve Bank of Australia due to inflation pressures suggests a more hawkish stance vs. the BoE's dovish tone.

After becoming constructive on EMBI last month, **we are further increasing our preference for credit and EM bonds by adding a positive stance on US IG**. This is based on the US' solid macroeconomic background, positive corporate fundamentals (solid balance sheets with high liquidity levels and coverage ratios), low risk of refinancing debt in the near term and stable leverage. Valuations also seem more attractive following the recent spread widening. Sentiment remains cautious on risky assets, but in the case of widening, US IG would be the most resilient, in our view.

**We continue to seek opportunities in the currency space as the divergences in economic and inflation patterns and monetary actions offer attractive themes to play.** In particular, we continue to be cautious on the EUR vs. the JPY and the USD. EUR valuations are less appealing vs. the greenback considering the current inflationary pressures. We maintain our positive view on CHF/EUR and our bias for the USD vs. CAD as the latter is a cyclical currency that can be damaged in a decelerating growth environment. We are no longer constructive on the USD vs. NZD, as after the NZD depreciation there is space for a technical rebound. In the EM FX space, we see potential for the BRL to outperform.

## Risks and hedging

**Increasing stagflationary risks and still-present geopolitical tensions suggest investors should maintain or even increase hedges**. Hence, we think investors should keep their protection on credit while readjusting hedges on the US equity markets in search of cost-efficient options that can enhance their overall protection

**Amundi Cross Asset Convictions**

| | 1 month change | --- | -- | - | 0 | + | ++ | +++ |
|---|---|---|---|---|---|---|---|---|
| Equities | ↘ | | | ■ | | | | |
| Credit & EM bonds | ↗ | | | | | | ■ | |
| Duration | | | | ■ | | | | |
| Oil | ↗ | | | | | ■ | | |
| Gold | | | | | ■ | | | |

Source: Amundi. The table represents a cross-asset assessment on a three- to six-month horizon based on views expressed at the most recent global investment committee. The outlook, changes in outlook and opinions on the asset class assessment reflect the expected direction (+/-) and the strength of the conviction (+/++/+++). This assessment is subject to change.

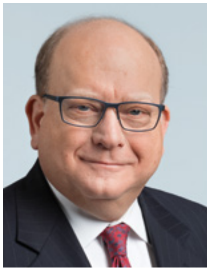
CGB = Chinese government bonds, EM = emerging markets, PBoC = People's Bank of China, FX = foreign exchange, IG = investment grade, HY = high yield, CBs = central banks, BTP = Italian government bonds, EMBI = EM Bonds Index, QT = quantitative tightening.

FIXED INCOME

# Fixed income now selectively more attractive

**Amaury D'ORSAY,**
*Head of Fixed Income*

**Yerlan SYZDYKOV,**
*Global Head of Emerging Markets*



**Kenneth J. TAUBES,**
*CIO of US Investment Management*

*The clouds on the economic horizon call for a move towards neutrality in duration and higher selectivity in credit, amid the diminishing liquidity*

Inflation and the economic growth outlook continue to be the key themes for bond investors. Central banks have started to act to tame inflation, with the Fed committed to delivering, but still data-dependent to prevent a hard landing of the economy. For the ECB, the task is slightly more difficult as the region is directly impacted by the continuing war in the form of higher energy prices and the risk of additional sanctions, which could exacerbate inflation even further. **After the great repricing in government bonds, we have been increasing our duration stance in a move towards neutrality and we remain cautious on the higher risk credit space.**

## Global and European fixed income

**We continue to adjust the duration stance in a move towards neutrality, but we retain different regional views**. In particular, we believe that the ECB may deliver less tightening than the Fed due to the higher risk of a recession in Europe. As a result, **we are less cautious than before on UK and Euro duration,** where we have a slightly short to neutral stance, while we maintain a short duration stance in the US. For diversification purposes we also maintain a **positive view on China duration and selective EM bonds**. We also continue to play curve opportunities globally, in particular in the Euro, Canadian and Australian curves.

The main debate in corporate credit is whether the risks related to earnings, higher rates and inflation are appropriately reflected in prices. We think not all segments are pricing in these factors. Consequently, we are reducing our credit risk stance, becoming more cautious on the higher risk space of the credit market, such as corporate hybrids, and we prefer higher grade credit with short to medium-term maturities. **Geographically, we are more constructive on US vs. Euro IG credit**, amid the better fundamentals in the US.

## US fixed income

Given the amount of tightening priced in by the markets, particularly in the front end of the curve, and the high geopolitical and economic uncertainty, we think **it's wise to move back towards neutrality on duration**, while keeping a tactical approach as market volatility is still high. **Credit offers opportunities** as corporate fundamentals are strong. Here we are selective, **with a preference for financials over industrials**. We are also actively tracking new issues, as they offer substantial concessions, but here too we look for idiosyncratic, bottom-up opportunities. We believe to tactically adjust their credit allocation stance, investors could use hedges through more liquid derivatives, as credit market liquidity is lower in a more volatile environment. **We continue to seek value in securitised assets**, as the 'consumer' remains strong in light of solid earnings and savings. **We look for value in agency MBS** as they could perform better than other areas of credit given some concerns around economic growth.

## EM bonds

Within the EM bonds investment universe we keep an overall cautious stance. **We maintain a short duration bias,** but we are slightly less defensive than before. **We favour HC bonds** and believe valuations are more attractive in HY vs. IG, but with a selective approach. Higher commodity prices are supportive for exporting countries, and in this respect, LatAm has been proving more resilient as it is economically and geographically distant from the ongoing war in Ukraine.

## FX

We maintain our **positive view on the USD** and are cautious on EUR, JPY and CNY. In EM, we are **constructive on selective FX in LatAm** (MXN, CLP), but cautious on the Eastern European currencies such as the HUF.

## Barclays Global Aggregate index yield


Source: Amundi Institute, Bloomberg, 25 May 2022

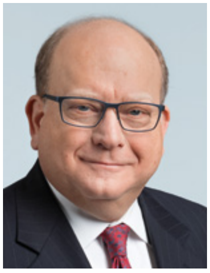
*GFI = global fixed income, GEMs/EM FX = global emerging markets foreign exchange, HY = high yield, IG = investment grade, EUR = euro, UST = US Treasuries, RMBS = residential mortgage-backed securities, ABS = asset-backed securities, HC = hard currency, LC = local currency, MBS = mortgage-backed securities, CRE = commercial real estate, QT = quantitative tightening*

## EQUITY

# Be mindful of excessive valuations and cyclical risks

**Kasper ELMGREEN,**
*Head of Equities*

**Yerlan SYZDYKOV,**
*Global Head of Emerging Markets*



**Kenneth J. TAUBES,**
*CIO of US Investment Management*

### Overall assessment

High inflation, the ongoing conflict in Ukraine, slowing economic momentum and the Covid lockdowns in China are causing volatility in the markets. This is happening at a time when forward earnings multiples have contracted from the levels seen last year, amid higher inflation and rates expectations.

**Overall, the focus on valuations remain key, as the expensive areas of the market will remain under pressure. Less cyclical value and quality are the places to look for resilience. Our overall approach remains that of selection, with a focus on earnings sustainability beyond the near term. Regionally, the US remains favoured within the developed world.**

### European equities

Challenges for the European markets continue. Higher inflation and slowing growth put pressure on company earnings, while rising rates put pressure on earnings multiples. We think current valuations do not price in a full recession, which is a risk for the Euro area.

In this environment, when the range of possible economic outcomes is wide and valuation dispersion is high, we think high-quality, less-cyclical value and defensive names are good options. As a result, we maintain a barbell approach**.** On the one hand, **we favour defensive names in the healthcare and consumer staples** (increased our bias) sectors. On **the other hand, we are selectively exploring quality cyclical stocks in the materials and industrial sectors**. In doing so, we are mindful of the economic headwinds and keep our focus on non-disrupted business models. We also remain cautious in the information technology and utilities sectors.

### US equities

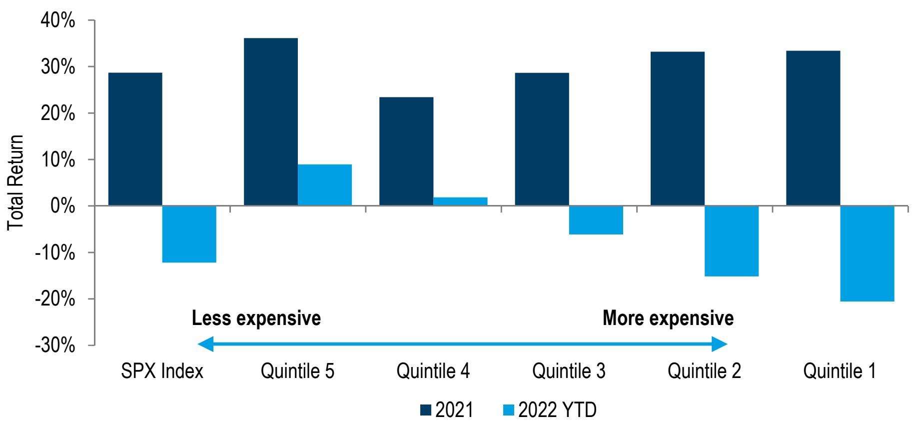
Despite the recent weak economic growth data, a recession is not our base case because labour markets and consumer balance sheets remain strong. Yet, in a rising rates environment, the pressure on valuation multiples will remain. Hence, we maintain **our quality and non-cyclical value tilt and we remain cautious on the high momentum/ growth side of the market.** We remain cautious on the mega-caps and are very selective and biased towards companies with high operational efficiencies, those that return cash to shareholders through buybacks and dividends, and can maintain earnings growth. We look for opportunities in energy and materials and we also like banks that display high returns on equity and selective consumer names. We believe the reopening would drive consumer spending, but we are monitoring labour availability and rising costs for companies and how that could affect margins and production. Interestingly, after the recent correction, selective technology names have become attractive, but we remain bottom-up in our approach and evaluate each name with respect to the quality of earnings. On the other hand, we are underweight mega caps and avoid unprofitable growth and distressed value names.

### EM equities

**Despite the high market uncertainty, EM valuations have certainly become more attractive, showing potential for appealing returns, but with strong divergences**. Thus, we remain selective, favouring commodity exporters (Brazil, UAE) and domestic consumption stories (Indonesia). In Asia, we are becoming more cautious due to expensive valuations and renewed inflation pressures.

*We believe it is key to remain cautious in unprofitable growth and expensive areas, while maintaining a core quality tilt*

**US equity valuation driven repricing: S&P 500 returns by PE quintile**




Source: Amundi Institute, Bloomberg, as of 25 May 2022

THEMATIC GLOBAL VIEWS

# Only innovation in fiscal and monetary rules will make the Eurozone viable

**Didier BOROWSKI,**
*Head of Global Views*

**As crises unfold, structural and governance issues tend to become more and more important. And the objectives of economic policy are increasingly ambitious, both on the fiscal and monetary fronts. The governments and the ECB are in an impossible situation. The "old rules", be it the Taylor rule for the ECB or the rules of the Stability and Growth Pact are outdated. That said, the absence of rules can lead to increased financial and macroeconomic volatility. Only "new rules", which have yet to be invented, will enable monetary and fiscal policy to meet the new challenges. It is up to the EU Member States to define, as a priority and in a concerted manner, the major strategic orientations.**

Structural and governance issues have become increasingly prominent from one crisis to the next. One of the thorniest issues in the Eurozone is fiscal policy, which remains the Achilles' heel of the European construction. The Eurozone is an incomplete monetary union, with a notoriously inefficient combination of a single monetary policy with independent fiscal policies that are too often left uncoordinated. And it is precisely during crises that we see just how inefficient the institutional framework is.

Meanwhile, public policy objectives are increasingly ambitious. We expect governments to fund the energy transition, to provide investment in infrastructures, education and healthcare, and to play a stabilising role during recessions. And we expect central banks not just to ensure price and financial stability but also to rein in financial fragmentation, while contributing to the energy transition.

This is like squaring a circle, with too many intertwined objectives for too few instruments, along with increasingly tough constraints (price stability and debt sustainability) for both governments and central banks. A combination of exogenous supply-side shocks and "uncertainty shocks" is clouding the economic prospects of the Eurozone, which, moreover and for the first time in its history, must deal with stagflationary pressures.

On the monetary front, a broad consensus has emerged in recent decades around pre-set rules. Taylor's rule has gradually taken hold but looks unsuited or inadequate. There's no point in (aggressively) raising interest rates to dampen inflationary pressures that result from a supply-side shock, unless it is being assumed that such pressures will spill over into wages and the general price level.

On the fiscal front, the rules of the Stability and Growth Pact are outdated. It makes little sense to impose a single figure on each country in terms of debt (60% of GDP) and the deficit (3% of GDP). Such rules have turned out to be pro-cyclical in the past. And sanctions have not worked.

Even so, this doesn't mean that purely discretionary action produces the best public-policy decisions. For a lack of rules could stoke financial and macroeconomic volatility. It is still essential to anchor market expectations. But how? Monetary normalisation is possible only through a coordinated approach to fiscal policy (to absorb the shocks). Strict separation between fiscal rules and monetary rules doesn't work. There was a "lucky" period of implicit coordination during the Covid crisis, when disinflation allowed the ECB to ease its monetary policy. This lowered the cost of borrowing and allowed fiscal policy to absorb the shock. It is now essential to explore how coordination can be made more explicit.

*The ECB should agree to separate its bond-buying programme from its key rate policy*

There are no quick fixes, but some avenues are worth exploring. The ECB's independence, naturally, is inviolable. But nothing keeps it from re-interpreting its mandate. First, it could take into consideration more explicitly the origin of the inflationary shock (i.e., supply- or demand-side) in following an "enhanced" Taylor rule. And, second and more importantly, the ECB should agree to separate its bond-buying programme from its key rate policy.

But to do so, the Stability and Growth pact will first have to be re-interpreted. In an initial stage, EU countries could agree on some key (existential) objectives and on the fact that they have more to lose collectively by not achieving them than from raising debt at European level. To determine the effort required to ensure national debt sustainability, it is essential to examine primary balances, debt burdens, initial debt levels, and ratios of government expenditure to GDP. This means that rules that are specific to each country would ultimately be more suitable (and more binding) than a single, deficit-based rule. There is also a need for multi-annual spending plans at the national level that commit governments to keeping recurrent expenditure growth below real GDP growth, while protecting capital expenditure. The focus must be on aggregates that governments control and that are measured explicitly. Governments and the ECB will only be able to meet these challenges through a pragmatic, coordinated and innovative approach.

*Finalised on 20 May 2022*

THIS MONTH'S TOPIC

**Éric MIJOT,**
*Head of Developed Markets Strategy Research*

**Joao TONIATO,**
*Equity Research Strategist*

*Energy contributed about 50% to 1Q earnings growth*

# A look under the surface of the first-quarter earnings season

**The excellent results of the first quarter also conceal weaknesses. Excluding energy, they remain positive but much less flattering, and companies are wondering about the future. Revisions are now expected to be on the downside, which does not rule out counter-trend rallies. Markets' behaviour could be tricky. Remain cautious.**

The earnings season has been positive on both sides of the Atlantic; as of 20 May, blended earnings growth was +11.1% YoY in the US, compared to +6.4% expected at the beginning of April; in Europe, the rebound was even more spectacular, as the economy took longer to rebound: +41.5% YoY compared to +20.8% expected at the beginning of April. However, these excellent results, although better than expected, are far from reflecting what could happen in the next two years.

## First of all, several remarks should be made about these results

On the positive side, we should already welcome the fact that these figures are better than expected in almost all sectors (except Consumer Discretionaries in the US and Consumer Non-Cyclicals in Europe). Moreover, while margins are falling in the US for the first time since the recession of 2020 (first-quarter revenue growth reported as of 20 May +13.8%, i.e., more than profits), they are still rising in Europe (revenue growth of +22.9%, i.e., less than profits).

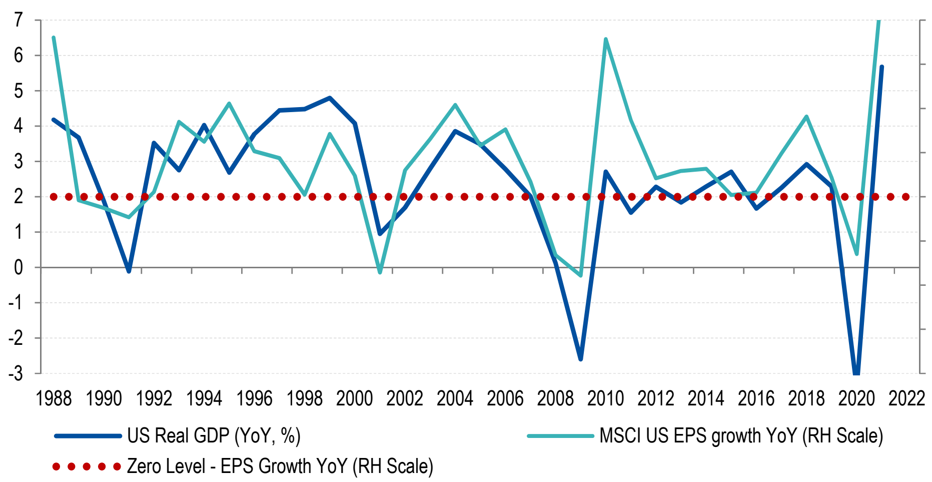
On the down side, this is largely backward-looking and, looking beneath the surface, there is little to inspire confidence about future earnings. About half of the increase is due to an exceptional contribution from the energy sector, which masks a less flattering reality; profits are up by only 4.9% in the United States and by 22.4% in Europe excluding energy, despite its low weighting in the stock market indices (only 3% of the MSCI USA and 6% of the MSCI Europe). Moreover, first-quarter results show little of the impact of the conflict in Ukraine, which began on 24 February. This implies that the next few quarters will be more challenging. Finally, beyond these figures, which reflect the past, companies have been getting gradually more cautious in their guidance for the remainder of the year and for 2023, given the conflict in Ukraine, the slowdown in China and the tightening of monetary policies.

## What do we expect next?

Financial analysts have once again revised their forecasts upwards to +9.3% and to 10.1% in the US for 2022 and 2023 and to +13.1% and +3.7%, respectively, in Europe, according to IBES. However, these forecasts seem to us to be exaggerated. Analysts' revisions for the full year were mainly due to this exceptional first quarter, especially for commodity-related sectors. As for us, in the US, we believe that growth at a high single digit [+5;+9%] is likely for 2022, slightly below consensus, but still good. In Europe, however, we think it should be between -5% and +5%, which is a more substantial potential revision.

Indeed, there is a historically strong relationship between real economic growth and earnings growth. This has been true since the late 1980s, a period long enough

1/ **GDP growth & EPS growth in United Sates**




Source: Refinitiv, WEO, Amundi Institute, Data as of May 2022

THIS MONTH'S TOPIC

*Downward profit revisions and counter-trend rallies are not incompatible*

*Seek above all secure returns and capital preservation*

to incorporate different inflation regimes. In the US, for example, real GDP growth of at least +2% is required to generate positive profit growth. Our economists expect +2.6% on average for the year. Moderately positive earnings growth would therefore be achievable; as for Europe, real global economic growth of +3.0% is required, which is precisely what our economists expect. Profit growth for the year as a whole should therefore be close to zero and even possibly shift to the negative side.

For 2023, GDP forecasts average +1.9% for the year in the US and +3.4% globally, with a downward bias; this is very close to equilibrium levels for profits and probably lower in 2023 than in 2022. It is therefore likely that the dynamics of profit revisions are now on the downside. Moreover, although the earnings outlook has been revised upwards by analysts, equity markets have been declining since the beginning of the year. P/Es have therefore contracted to below their historical average in Europe and are close to their average in the case of the United States; at this stage of the cycle, i.e., in an economic slowdown phase, it is usual for the decline in P/Es to be a precursor of downward earnings revisions.

### What impact will this have on our main equity investment areas?

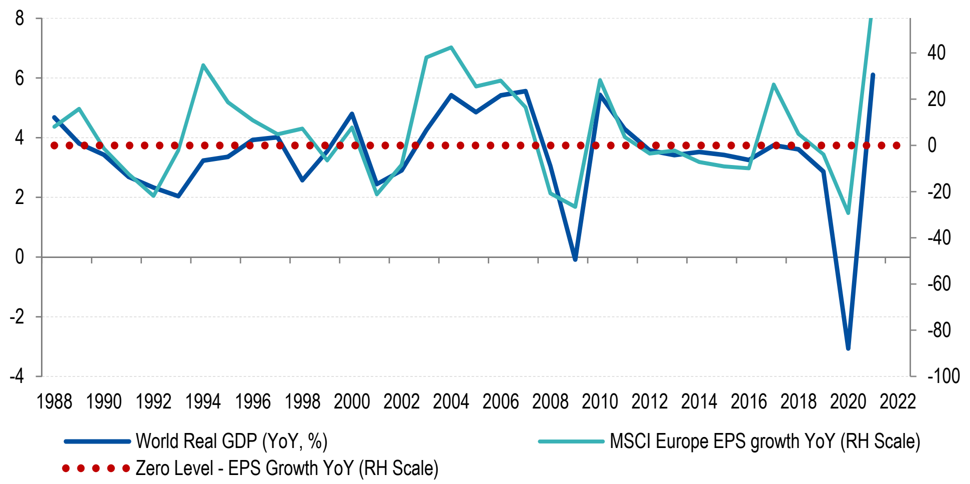
**At the directional level, the next few months could hold some surprises and should be characterised by volatility.** If the spike in inflation were to bend the Fed's hawkishness, for example, and allow the market to consider for a time that a recession is avoidable, this downward revision of profits could take shape while the equity markets, paradoxically, begin a counter-trend rally. From current levels, such a rally in equities becomes an increasing possibility. However, it is best not to take too strong a stance on this as the longer-term trend is likely still downwards.

**Regionally, some preference for the US over the Eurozone could be argued at the margin on the greater resilience of earnings growth as described above. However, the regional allocation is not a clear cut.** Indeed, the valuation differential is clearly in favour of the Eurozone. Its P/E relative to that of the MSCI World has fallen to a level reached during the Covid crisis in 2020, the Great Financial Crisis of 2008 and even the EMS crisis of 1992. Any progress on the resolution of the conflict in Ukraine would thus be likely to trigger a significant rebound in Eurozone stocks. However, geopolitical risk is likely to remain and the current global slowdown, as long as it is not challenged, is not conducive to a sustainable comeback of investors to this area. Conversely, in the case of the US, the repricing of growth is a headwind, but the better resilience of earnings is a relative support.

In terms of styles, our approach is diversified. Our preference is for: 1) **Value, given the rise in real rates;** However, we are starting to question the link between Value/Growth at the global level and US 10-year TIPS, which has been so strong since TIPS moved into negative territory in 2020, while they are now shifting into positive territory again. The Value opportunity may no longer lie in the classic sense of searching for the cheapest stocks in the index but in finding high Quality names that now trade at a significant discount to their own historical valuation and/or to the index as a whole; 2) **Quality, given the maturity of the cycle**. This factor will respond very well to any widening of high yield spreads if it were to occur; 3) **High dividends, as dividends generally track inflation while being an important part of the return when expected equity returns are under pressure;** the low volatility of this factor in a world now characterised by rising volatility is another argument; 4) **Minimum volatility, which is precisely more defensive** and outperforms when capital preservation becomes essential.

**What should be avoided: 1) Small caps, because of their cyclicality;** while this makes

2/ **Global GDP growth & EPS growth in Europe**




Source: Refinitiv, WEO, Amundi Institute, Data as of May 2022

THIS MONTH'S TOPIC

them a very attractive asset at the beginning of the cycle, it makes them less attractive when the cycle turns. The rise in high yield spreads would be particularly unfavourable for them. **2) Momentum, as the current stage of the cycle plays for selling the rallies**, no more buying the dips as it used to be in the more fundamental previous phase, when economic growth and companies' earnings were accelerating. **3) Pure growth, i.e., stocks supposed to have growth but where quality does not follow.** These stocks have already fallen a lot; but beyond the rebounds in any short-term rally, which can be sudden, it will take time, like during the dotcom bubble burst, for investors to regain lasting confidence in them.

**At the sector level, caution and flexibility are also required.**

While defensiveness is a key characteristic to focus on at this stage, we would especially focus on defensiveness of profitability, pricing power and sustainability of margins/earnings. Often this will mean defensive sectors, but in some cases, cyclical sectors can offer those, as well, which is an argument for looking into some granularity and an opportunistic angle.

Commodity-related sectors, notably Energy, might have further upside as their outperformance is based on actual and significant earnings revisions. However, if we accept that in the next stage of the cycle commodity prices will have to correct, even partially, the case for starting to book profits and reduce the overweight becomes a strong one. The Mining sector should already have been avoided, given its large exposure to and dependence on the Chinese market at a time when lockdowns are having a significant impact on activity. This is a strong headwind for the sector. In addition, we see a strong case for any positions reduced in the Mining sector to be moved to other areas within the broader Materials sector, namely Chemicals and, to a smaller extent, Construction. The more defensive nature of the Chemicals sector looks attractive at this stage. Construction, in turn, offers opportunities, especially for stocks exposed to fiscal stimulus and government investments, which should have their profitability protected through the downturn.

Technology remains a challenging area and we would not move back into the sector at this stage. Within Tech, however, we can see the Software industry offering advantages, as it is more defensive than Semiconductors and Technology Hardware and tends to display more resilient profits in downturns.

Otherwise, the core of the portfolio should be based on the so-called defensive sectors. Even if their earnings growth has lagged that of most cyclicals during this first-quarter earnings season, the ongoing economic slowdown should reverse the hierarchy in their favour in the coming quarters. Healthcare has been the preferred defensive play for most market participants and had a very significant run, so we need to be more selective when looking for opportunities in the sector. There is a very wide dispersion in valuations within the Pharma sector that can be exploited. Staples is a very diverse sector and once again we see a wide dispersion in valuations, especially within the Household & Personal Care sub-sector and the closing of those valuation gaps could offer opportunities.

*Finalised on 24 May 2022*

THEMATIC

# JPY: Structurally weak, cyclically blessed

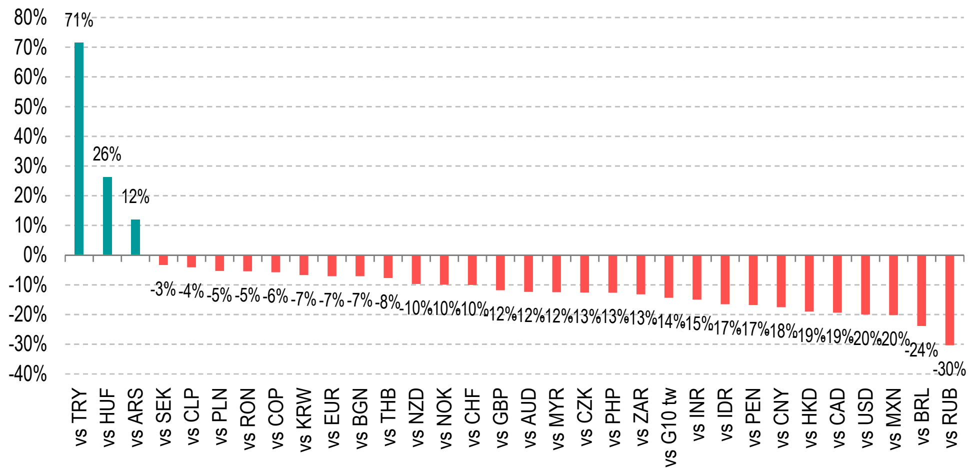
**Structural headwinds are strong for the yen, setting a fundamental background for the currency to stay weak. Yet a recessionary environment is a cyclical blessing – peaking growth and rates prove that the JPY is among the cleanest diversifiers – and officials may have lost their appetite for currency devaluation.**

**Federico CESARINI**
*Head of DM FX, Cross Asset Strategist*

**Claire HUANG,**
*Senior EM Macro Strategist*

Two years after the first Covid-19 outbreak in developed markets, the JPY is among the clear losers globally. With respect to December 2020 – when the new US administration was coming into power – the currency has weakened against all major trading partners with few exceptions, including the TRY, HUF and ARS. The movement, which has been extreme compared to the USD, RUB, BRL and MXN (where the JPY's depreciation goes from -20% to -30%), has been strong and broad-based, with both cyclical and fundamental reasons backing the trend.

### 1/JPY depreciated against almost all trading partners




Source: Bloomberg, Amundi Institute. Data as of May 18 2022

At this stage, and given the huge increase in prices of commodities and raw materials globally, Japanese officials have started questioning whether the positive externalities of a weaker currency are materialising or, rather, whether the time has come to intervene in the FX market[1].

The goal of this paper is to assess whether conditions supporting a weaker JPY are still with us. We will go into JPY fundamentals in detail (weak and far from pre-pandemic levels), leverage our own expectations on the global economic cycle (and its impact on the currency), assess the net effect of a weaker JPY on the domestic economy and, finally, explain why intra-Asia competition may additionally prevent further depreciation going forward.

*Structural weakness at play. Whilst most trading partners have recovered pre-pandemic patterns, Japan has lagged behind, with a deep output gap that is not expected to close before 2024*

### Fundamental headwinds are strong for yen...

Covid and CB and government intervention in response have created huge distortions at the global level. Yet Japan is among the places where fundamentals weakened the most across developed markets, creating structural support for its currency to weaken.

Whilst most trading partners have recovered pre-pandemic patterns, Japan has lagged behind, with a deep output gap that is not expected to close before 2024. Its post-pandemic recovery lacks the same level of momentum as in the US or the Eurozone. On top of chronically deficient demand, the Japanese economy had already been hit once before Covid by the consumption hike in October 2019. Consumer inflation had stayed subdued until lately.

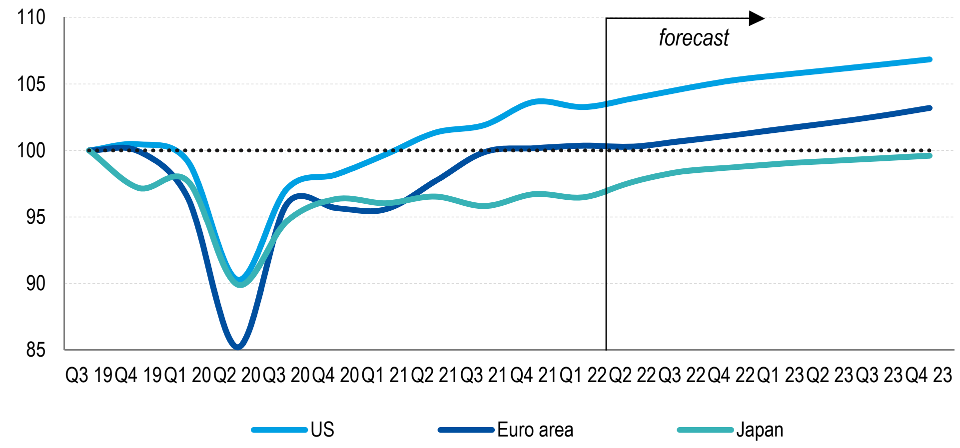
Against this backdrop, BoJ has repeatedly stated that the cost-driven increase in inflation is not sustainable. It has maintained its ultra-loose monetary policy and defended its YCC target range by committing to buy unlimited amount of JGBs, making JGB the most attractive solution for funding carry strategies[2].

[1] *"A rapid change in foreign exchange rates is undesirable from anyone's point of view," Kishida said in an interview with Nikkei at the Prime Minister's Office in Tokyo. "The lives of people and operations of businesses are impacted by elevated prices of commodities amid the weak yen."*

[2] *Carry strategies go long the bond with the highest interest rate of a given country, by financing the position (i.e., by funding the strategy) by shorting the bond with the lowest interest rates (i.e., Japanese bonds in the latest two years). On this point, we do not see structural changes in sight for the next few months.*

THEMATIC

### 2/Japan's economic growth gap with others



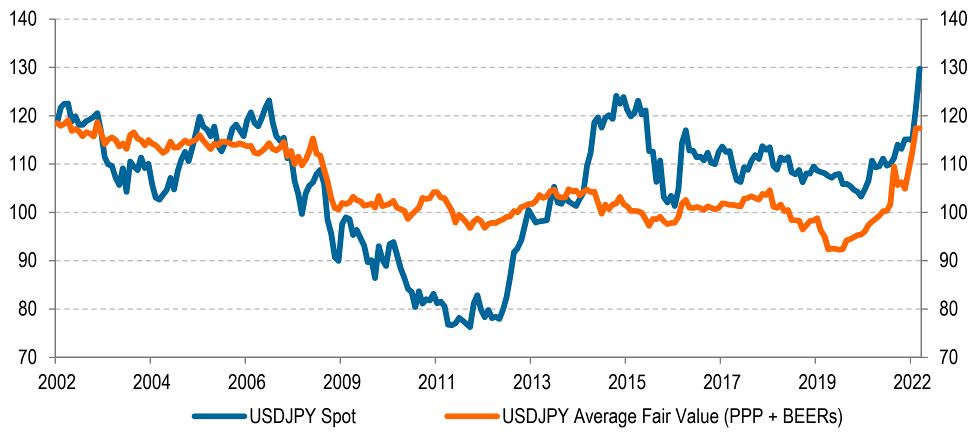

Source: CEIC, Amundi Institute. Data as of May 2022.

Moreover, as a commodity importer, Japan is particularly sensitive to the global supply chain shock and to rising commodity prices. The deterioration in terms of trades has been unprecedented. From the beginning of 2021 to April 2022, Japan's import prices rose 63%, a much steeper rise than export prices (25%).

Despite its relatively muted inflation versus the rest of the world – which, in turn, made the currency more and more attractive from a PPP perspective – USD/JPY's fair value has collapsed in the last two years. According to our own calculation[3], USD/JPY's fair value has moved consistently with spot, thus providing a fundamental background for a weaker currency. From this perspective, it will be hard to go back soon to old levels.

*Should the global economic cycle enter a recessionary environment, the JPY would be among the cleanest diversifiers*

### 3/USD/JPY vs average fair valuation. Fundamentals stay weak




Source: Bloomberg, Eikon. Based on Amundi Institute calculation. Data as of April 29, 2022.

### ...but a recessionary environment is a cyclical blessing

Not all moves in JPY crosses have been based on fundamentals, though. With a global recovery in progress and with global yields strongly outpacing Japan's, JPY weakness has simply worsened, consistent with historical patterns. Needless to say, the recovery has entered its mature phase and stagflation probability has increased substantially in recent months.

Should the global economic cycle enter a recessionary environment, long-term rates would have to react and disconnect with short-term monetary policy decisions. At that time – and till the peak in Fed hawkishness[4] – the JPY would be among the cleanest diversifiers and make up part of its recent losses. We report below the historical simulation of G10 FX yearly returns when US rates – our global proxy – rise or fall, based on growth.

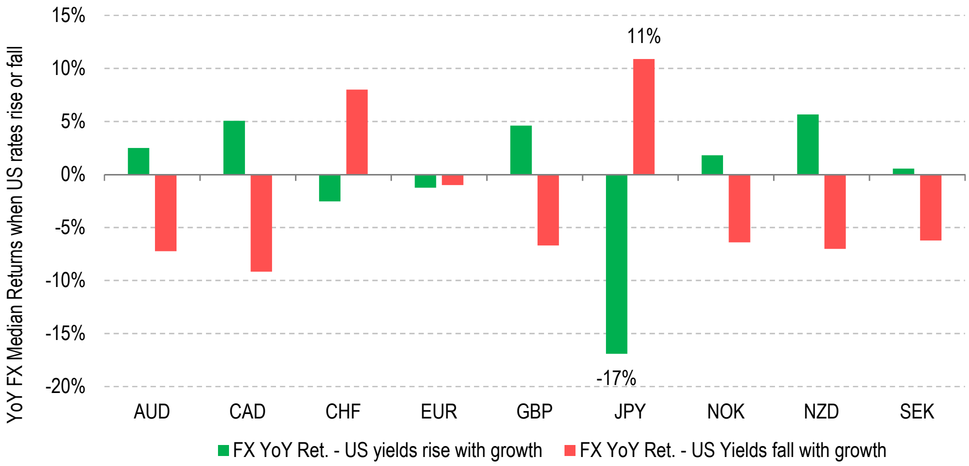
[3] *The battery of our fair value models include: PPP and the three BEERs model, which leverages on growth and productivity differential, rates differential, terms of trades, and fiscal spending. But for PPP (where USD/JPY is cheaper than pre-pandemic levels), fair valuation for JPY has weakened massively in the latest two years.*

[4] *A Fed's dovish U-turn is a prerequisite for turning short on the USD. The JPY will not be the only one to benefit from the move.*

THEMATIC

*The "J" curve, which links exchange rate dynamics to the balance of payments, has disappeared in Japan since the Abenomics era*

4/ **G10 FX yearly patterns in different US rates regimes**




Source: Bloomberg, based on Amundi Institute calculation. Data as of April 29, 2022.

## Policymakers lose appetite for currency devaluation

While a weak currency is usually a boost for external demand – exported products are cheaper for foreigners – empirical evidence suggests Japan is no longer a beneficiary. The "J" curve, which links exchange rate dynamics to the balance of payments, has disappeared in Japan since the Abenomics era. The reason is that Japan now produces high-value-added products – where prices are unable to be used to gain market share – whilst cheap products are left to other Asian countries. The real activity benefiting from a weaker currency rely only on the income effect, but, at a juncture where production costs are rising globally, the net effects on growth are questionable, to say the least.

Nonetheless to say, the Japanese government has to maintain a fine balance between its geopolitical interests and the economic benefits from a weaker yen (if that happens). In this respect, we have to distinguish between mechanical vs competitive factors.

Some currencies (e.g., CNY and SGD) have the JPY within their pegging mechanisms: they will have to let their currencies weaken vs the USD, the more JPY weakens. Korea, Taiwan and others, on the other hand, would find a competitive incentive in lowering their exchange rates, thus keeping Japan from getting most of the external demand on their same offering.

Summing up, whilst 2021 saw both structural and cyclical forces in support of a weaker JPY, we see a regime shift for 2022 onwards. Fundamentals still justify a weak currency, and we see no imminent risks that the BoJ will change its dovish stance. Yet cyclical forces and competition challenges suggest most of the movement should be behind us. We see limited depreciation from current levels and expect a reversal of some of the recent losses over the next 12 months.

*Finalised on 27 May 2022*

## CENTRAL & ALTERNATIVE SCENARIOS (12 TO 18 MONTHS HORIZON)

### Monthly update

We keep the probabilities of our central and alternative scenario unchanged versus last month but amend the narrative to take into account the evolving geopolitical situation (see Ukraine crisis tree).The new wave of Covid-19 in China and stagnation in the Euro-area are adding growth uncertainty over the short-term.

### DOWNSIDE SCENARIO 30%

**Renewed slump toward stagflation**

**Analysis**

- **Long-lasting war in Ukraine** is hurting confidence and activity, and pushes commodities and energy price higher for longer and disrupting supply.
- **Covid-19** resurgence leads to global renewed mobility restrictions and bottlenecks disrupting supply chains.
- Both triggers lead to an **economic downturn** while **inflation** remains elevated and uncontrolled.
- **Several EM** default and public debt sustainability in DM.
- **Renewed monetary and fiscal accommodation** to support the economy, possibly a further step in financial repression.
- Inflation amid slower growth, forces some **Central Banks** and the ECB in particular, to **deviate** from their guidance and potentially lose credibility.
- Policies and investments designed to fight **climate change** are postponed and/or countries policies are disorderly implemented.

**Market implications**

— Favour cash, USD and US Treasuries
— Play minimum-volatility strategies
— Gold
— Commodities and energy

### CENTRAL SCENARIO 60%

**Bumpy road, regional divergences**

**Analysis**

- The **war in Ukraine** is hitting confidence and pushes commodities and energy price higher temporarily.
- **Covid-19 is an endemic disease,** with random contagion waves (China); global activity holds up, but supply-chain bottlenecks to persist.
- **More growth divergence:**
  • Global growth progressively abate to trend in 2022, opening 2023's to downside risks.
  • Soft patch in H1 2022 due to China's GDP contraction in Q2
  • Stagnation or technical/short-lived recession in Europe and the UK
  • The US economy is resilient, but expected to slow down: towards subpar growth in 2023.
- **Headline inflation is peaking,** but will remain elevated. High commodity prices, supply-side bottlenecks and rising wage pressures will push core inflation up in some regions (e.g. the EZ).
- **Monetary policy asynchrony:**
  • Fed in fast move from tapering to QT and a steep hiking cycle (H1); but the Fed should slow the pace of rate hikes in H2
  • BoE in a soft hiking cycle,
  • ECB to end QE and hiking rates 3x in 2022, but no room for a real monetary tightening
  • PBoC on an easing bias.

  Bond yields to move higher but to stay low for longer.
- **Fiscal policy:** to smooth the short-term impact of energy prices (through targeted measures, notably in Europe).
- **Climate change** disrupts the commodity cycle and adds to stagflationary trends.

**Market implications**

— Lower risk-adjusted real returns expected
— Contained steepening of US Treasuries yield curve as well as EZ and EM
— Inflation hedge via gold, linkers and equities
— EM: Short-term caution, long-term real income and growth story intact

### UPSIDE SCENARIO 10%

**Inclusive and sustainable growth**

**Analysis**

- **End of the Ukraine war** and sanctions are gradually withdrawn. Lower energy and commodity prices and inflation falls back quickly.
- **Endemic recedes f**aster than anticipated, despite variants.
- Extra savings and wage rises fuel **consumption** with low erosion of corporate margins.
- **Productivity gains** thanks to digital and energy transitions and structural reforms
- **Inflation** remains under control and CBs are gradually normalising.
- **Higher nominal and real interest rates**, due to stronger investment and less savings.
- **Debt is sustainable** thanks to strong growth and a gradual shift towards fiscal discipline.
- **Inclusive growth** and effective fight against inequality.
- **Climate change** policies and energy transitions become first priority.

**Market implications**

— US Treasuries curves bear steepen
— Favour risky assets with cyclical and value exposure
— Favour linkers and equities as an inflation hedge

*Geopolitic* · *Covid-19 related topics* · *Growth and inflation expectations* · *Monetary and fiscal policy* · *Recovery plans or financial conditions* · *Solvency of private and public issuers* · *Economic or financial regime* · *Social or climate related topics*

## TOP RISKS

### Monthly update

We increase the probability of financial risks to 30% from 20% as economic fundamentals are deteriorating. We keep the probability of economic and geopolitical risks to 30% to take into account the war in Ukraine and its potential implications on the economic. We consider Covid-19-related risks (including lockdowns in China) to be part of the economic risks. Risks are clustered to ease the detection of hedging strategies, but they are obviously linked.

### ECONOMIC RISK 30%

- **Global recession** driven by an oil and gas shock, and a deteriorating sentiment as the war in Ukraine stalls
- **Economic crisis in Eastern Europe** following a collapse of the Russian economy, elevated energy prices, uncontrolled inflation and a migrant crisis
- **Pandemic 3.0**
  - After Omicron (2.0) a more dangerous and vaccine-resistant variant starts a new wave
  - New lockdowns or mobility restrictions could further undermine the global recovery
- **Supply chain disruptions** carry on (China lockdowns), and input cost pressures lead to corporate earnings recession
- **China zero Covid policy combined with regulatory crackdown and property market collapses,** leading to lower growth prospects
- **Monetary policy mistake**
  - Central banks' miscommunication in the context of a high geopolitical uncertainty
  - Central banks underestimate the strength of supply driven inflation and lose control
- **Climate change-related natural events** hurt growth visibility and social balance.

**+** **Cash, linkers, JPY, Gold, USD, Quality vs. Growth, Defensive vs Cyclicals, Oil**

**-** **Risky assets, AUD CAD or NZD, EM local CCY**

### FINANCIAL RISK 30%

- **Sovereign debt crisis**
  - An extended war in Ukraine would hurt DM vulnerable public finance with public debt as a share of GDP already at historically high levels
  - De-anchoring inflation expectations could lead to harsher monetary tightening and a bond market dislocation
  - Most countries are vulnerable to rating downgrades and rising interest rates
  - EM weaknesses could also face a balance-of-payments crisis and increased default risks
- **Corporate solvency risk increases,** amid deteriorating fundamentals, rising uncertainty and corporate margins under pressure (high input cost, double orders lead to profit warnings)
- **Widespread greenwashing and ESG investment bubble** undermine the energy transition funding
- **USD instability** and gradual loss of its reserve currency status lead to unstable currency markets
- **Currency wars:** currency appreciation is a way for CBs to fight inflationary pressures

**+** **CHF, JPY, Gold, CDS, optionality, Min Vol**

**-** **Oil, risky assets, frontier markets and EMs**

### (GEO)POLITICAL RISK 30%

- **War in Ukraine** *
  - Short term resolution following Russia military success: markets instability remain as investors are starting to price in Putin crossing new red lines
  - Prolonged military struggle leading to a high intensity conflict and potentially western military confrontation
- **EU political fragmentation** or populist vote bring a disagreement on how to manage the relationship with Russia
- **The US takes a hard line with China** in order to block any tentative to invade Taiwan. Risk of accidental confrontations in the South China Sea or the Taiwan Strait
- **EM political instability driven by** Higher food and energy prices, leading to a wave of unrest similar to the Arab Spring
- Iran or Korea nuclear programs renewed concerns and sanctions
- **US & China lose credibility** on the energy transition and undermine the Paris agreement
- **Global warming** leads to an increased risk of conflicts, driven by water shortages and migratory movements
- **Cyber-attack or data compromise,** disrupting IT systems in security, energy and health services

* ***For more detailed on potential outcomes see "Ukraine crisis tree" P. 17***

**+** **DM Govies, Cash, Gold, USD, Volatility, Defensive, Oil**

**-** **Credit & equity, EMBI**

## Ukraine Crisis Tree

**[A]**

**Russia has shifted its focus to the Donbass region and has won the battle of Mariupol. Peace talks have stalled, and no resolution seems imminent. Russian nuclear forces are on high alert.**

| **[B] Short-term resolution with limited military escalation** | | | | **[C] Prolonged (low-intensity) military conflict or global military escalation** | |
|---|---|---|---|---|---|

| | **[B1] Sanctions and diplomatic talks end the conflict** | **[B2] Russia controls Donbass and the area north of Crimea; conflict ends** | **[B3] Russia's controls east and south Ukraine; conflict extends to Moldova** | **[B4] Unrest or military putsch ends Putin's regime** | **[C1] Low-intensity conflict with limited supply-chain disruptions** | **[C2] High-intensity conflict** |
|---|---|---|---|---|---|---|
| **Economic impact** | • Partitioning or demilitarisation of Ukraine (neutral status).<br>• CBs back to MP normalisation.<br>• Market relief, but risk of EU profits recession.<br>• High but stable energy prices until supply diversification materialises. | • Partitioning or demilitarisation of Ukraine (neutral status).<br>• EU GDP contraction, inflation at 8-10%.<br>• Risk of EU profits recession.<br>• High energy prices on limited replacement capabilities. | • Full sanctions on Russia which enters an economic and financial crisis that spills over into EE.<br>• EU GDP contraction, inflation at 8-10%.<br>• Markets price in Russia's crossing of new red lines.<br>• EU profits recession.<br>• High energy prices on limited replacement capabilities. | • Russia enters an economic and financial crisis that spills over into EE.<br>• Uncertainty on Russia's political situation.<br>• EU GDP contraction, inflation at 8-10%.<br>• EU profits recession.<br>• CB back to normalisation.<br>• High and volatile energy prices. | • Global stagflation.<br>• Oil price down to \$75-80/barrel by Q1 2023 or to \$60-65/ barrel in case of some diversification over the next 12-18 months.<br>• EU GDP back to potential but inflation stays above 3%. | • Worst case includes Western and Russian military confrontation.<br>• Global GDP contraction similar to the GFC or Covid-19 crisis.<br>• EU GDP contraction (-4.5/-2.0%), with energy rationing.<br>• Double-digit inflation on severe commodity shortage. |
| **Market reaction** | • **Positive:** EU and Chinese equities, EM credit.<br>• **Negative:** govies, commodities (energy and gold). | • **Positive:** safe-haven assets (USD), oil prices (\$100-120/bbl.).<br>• **Negative:** liquid assets and EUR. | • **Positive:** USD and gold, oil prices above \$120/bbl.<br>• **Negative:** equity markets (with US outperforming); bond yields collapse. | • Yield curves flatten.<br>• **Positive:** high-dividend and quality equities. Within EM, favour LatAm and China.<br>• **Negative:** EUR, EM FX. | • **Positive:** real assets equities and commodities.<br>• **Negative:** EM debt and DM credit. | • Markets capitulation.<br>• **Positive:** for UST, secured real assets, USD, gold.<br>• **Negative:** all risky assets. |

*Source: Amundi Institute as of 28 May 2022. EM: emerging markets, CB: central banks. FX: foreign exchange. USD: US dollar. EUR: euro. CNY: Chinese yuan. LatAm: Latin America. EE: Eastern Europe. GFC: Great Financial Crisis. USD: US dollar. EUR: euro. UST: US Treasuries.*

## CROSS ASSET DISPATCH: Detecting markets turning points

Monthly update: The traffic light on sentiment has turned from orange to red.

The turning point has occurred | Approaching the turning point | Not reached yet too early to call it

### ECONOMIC BACKDROP

- Economic momentum is slowing progressively amidst higher inflation and weakening domestic demand, as food and energy inflation hit purchasing power, operating as a regressive tax.
- Directions of revisions on inflation and growth outlook keep diverging. Stagflationary momentum is particularly evident in the Eurozone.
- The prolonged stress on commodities and energy prices, leading to more persistent inflation and tighter monetary policies is exacerbating economic uncertainty, given a much less benign picture for the growth and inflation mix.

### FUNDAMENTALS & VALUATION

- The recent correction has left markets lees expensive, although the recent worsening in the macro picture is keeping current levels from being considered as solid entry points.
- QT will address inflation issues, keeping multiples from expanding, while expectations are still very optimistic, at least in Europe, considering the potential shortages of raw materials.
- All in all, valuations and current levels after the correction cannot offset the lack of visibility in profits going forward, thus making a risk-on mood impossible.

**NEUTRAL + ASSET ALLOCATION**

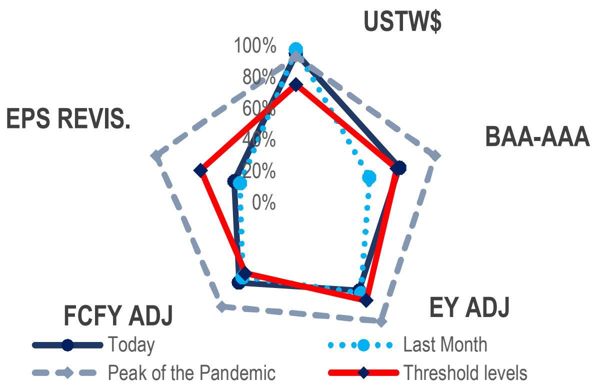
### TECHNICALS

- The recent correction in risky assets cleaned up most contrarian metrics, most tilted to upside moves moving forward. Yet contrarians need triggers and the current poor visibility over the backdrop may still call for a conservative approach.
- Risky assets trends remain fragmented, overall resulting in neutral exposure from a technical perspective.

### SENTIMENT

- The correction in risky assets continued in May, with spikes in most risk sentiment metrics.
- Risk concentration in the market is high and the overall risk-OFF probability is loudly calling for a defensive asset allocation.
- Financial conditions, whilst widening everywhere, are showing greater resiliency than in previous equities corrections. The Moody's Baa-Aaa *spread* is breaching alerts for the first time since 2020.

### Cross Asset Sentinels Thresholds (CAST) still supportive




Source: Amundi Institute, Data as of 20 May 2022

**The CAST risk perception failed to show a structural increase in Q1. EPS revisions have started showing a less benign global outlook, and the USD remains the dimension calling loudly for risk-off. Yet credit risk premiums failed to jump above our alert threshold (i.e., 100 bps) and are partially balancing the overall assessment.**

**Methodology:** We consider five inputs, which we call "sentinels": USTW$, Moody's Baa-Aaa, EPS revisions, Adjusted Earnings Yield Risk and Adjusted Cash Flow Yield Risk. These sentinels are used to reposition our tactical asset allocation. Once sound thresholds are detected, the five variables are aggregated as an indicator that anticipates the market's stress conditions, with a certain level of conviction. The pentagon visualises the five sentinels, where the red line represents the alert threshold. The greater the distance above the red line, the greater the risk perception, and eventually the need to move closer to a defensive asset allocation.

## GLOBAL RESEARCH CLIPS

### 1 Mounting recession risks

- We expect Eurozone stagnation amidst high inflation and potentially a recession in 1H22, whilst, in the US, a soft landing is possible (recession risks: 20% 12M ahead and 40% 18M ahead).
- We expect the Fed to deliver hikes as the markets expect in the next 12M, but the ECB and the BoE will manage to tighten less than expected by the consensus.
- Eurozone consumers are facing a new shock with fewer tools to offset it, due to weaker wage growth and a severe loss of confidence. For companies are witnessing renewed stress on input prices and more uncertain prospects on demand. After flattish to negative growth in Q1, the Eurozone G4 is flirting with contraction again.
- The US has relatively strong fundamentals (recovery completed under many fronts) to withstand the storm of high inflation. Eurozone fundamentals are more fragile and more vulnerable to the new shock (with an incomplete recovery under many fronts).

**Investment consequences**

- Central banks' terminal rates:
  - US @ 3.25% (in line with market forecasts),
  - ECB @ 0.5%
  - BOE @ 1.5% (both dovish vs markets)
- We remain cautious on Eurozone peripheral bonds, long on 5y5y inflation in the US and Eurozone.

### 2 Italian debt sustainability in light of higher yields?

- Debt/GDP will increase if the average yield on 7y maturities moves persistently above 3.4%.
- Yet ECB interventions will ultimately depend on the degree of fragmentation, i.e., elevated and persistent increase in the spread.
- Nominal growth and cost of financing are crucial for debt sustainability:
  - Long-term nominal GDP at 3.4% could offset a further increase in cost of debt as long as there is fiscal discipline (with a primary balance at 0%);
  - Debt sustainability becomes problematic with a strong, persistent, widespread and greater shift in the yield curve and an idiosyncratic increase in Italian yields;
  - Italian fundamentals, however, are in a better position to handle monetary policy tightening than in 2011 or 2018.

**Investment consequences**

- Cautious on peripheral debt as ECB stops QE, amidst stronger fundamentals in the longer term

### 3 Equity valuations: not pricing in the increased risk of a recession in the Eurozone

- In developed markets the 2022 corporate earnings cycle will end below consensus expectations. (see article page 9)
  - US EPS growth should be in the high single digits [5%;9%] vs the consensus +9.8, albeit with the support of buybacks.
  - In Europe a profits recession [-5%;+5%] can't be excluded, whereas the consensus expects a 11% earnings growth.
  - European EPS growth will be slower than in the US due mainly to expected weaker economic growth; we forecast +3.0% global GDP growth this year and only 2.3% in the Eurozone
- In emerging markets, EPS growth for Q1 2023 is expected at 7.5% vs consensus 10%.
  - Earnings revisions are pointing down: still positive in Latam and EMEA but negative and deteriorating further in EM Asia and China.
  - Chinese earnings growth expected in line with EM (+7.5% in Q1 2023).

**Investment consequences**

- With average US growth at 2.6% in 2022, US EPS will still manage to deliver low single-digit growth. European earnings should instead prove less resilient than in the US (and at risk of a profits recession).
- We remain neutral on equities and look for relative value strategies.
- Our preferences are for value in the context of rising real interest rates, quality given the maturity of the cycle, high dividends to offset inflation and minimum volatility.
- We would avoid cyclicals, small caps and momentum strategies

## GLOBAL RESEARCH CLIPS

### 4 Credit: stay cautious as the global picture is deteriorating

- Corporate credit is facing the challenges of a deteriorating economy, margin pressures and tighter monetary policy:
  - A deteriorating global picture, particularly in the Eurozone. Still elevated inflation is keeping CBs in tightening mode, with a risk of triggering a sharp slowdown or recession;
  - Increasing divergence among business fundamentals. Margin pressures on: rising wages, costs of materials, energy, and transport. Pricing power will be key;
  - Valuations are not pricing in the increased risk of a recession in the Eurozone;
  - Technicals are becoming less favourable with the end of ECB's CSPP.
- In less favourable credit conditions: economic backdrop deteriorating, CBs tightening, increasing divergence in business fundamentals and margin pressures.
- EM HC is cheap in terms of short-term dislocation assuming stabilising US 10y yields, strong oil prices till Q3 2022, and an improving EM-DM gap in 2022.

**Investment consequences**

- In DM we favour US vs Europe and prefer the short-duration segment.
- In EM we prefer hard currency. We expect spread tightening from current levels mainly in HY

### 5 China: growth outlook clouded by zero-Covid policy

- Full-year growth below 4%: Q1 growth came in firmer than we expected at 4.8% YoY, defying strong negative base effects.
- However, the broad slowdown in March economic activities, the extended lockdown in Shanghai and expanded zero-Covid policy in other regions will send China into a transitory recession in Q2.
- High-frequency indicators suggest activities outside of Shanghai herald a gradual recovery in May-June
- We are keeping our growth forecast below the consensus at 3.5% for 2022 (Reuters 5%, Wind 5.2%) and expect a rebound to 5.4% in 2023.
- The PBoC opts for a slow depreciation in currency, so we should expect more RMB weakness ahead.

**Investment consequences**

- USD/CNY targets increased to 6.95/6.50 for 6m/12m (from 6.5/6.3)

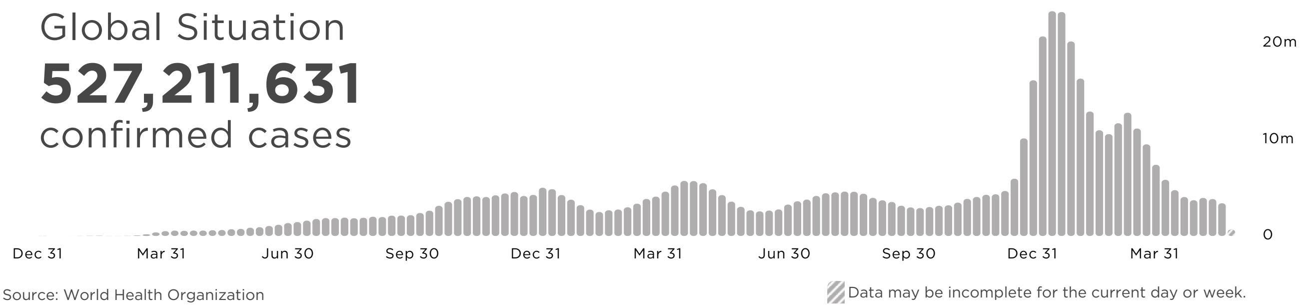
## Covid-19 situation update

**Pierre BLANCHET,** *Head of Investment Intelligence*

The broad wave of Covid-19 Omicron has receded. After peaking in January at more than 20 million cases a week, volume has been divided by 10 and WHO statistics are now tracking around 2 million cases a week globally. More importantly, the number of deaths has never been so low since March 2020.

In China, which has had to suffer another wave since March, daily cases have fallen below 100, according to official statistics. It seems that the virus outbreak is easing, following months of tight restrictions and in particular a full lockdown of the Shanghai region. However, infection risk in northeast China (Hebei) is still growing. Even in North Korea, where the situations looked uncontrolled, recent announcements of an easing in lockdowns are confirming an improvement.

These are reassuring signs, and although we should expect the virus to stay active, these data confirm our view that Covid-19 has moved from a pandemic to an endemic disease with a lower impact on supply chains, consumer demand and economic activity overall.




Source: World Health Organization

## AMUNDI ASSET CLASS VIEWS

| | Asset Class | View | 1M change | Rationale |
|---|---|---|---|---|
| EQUITY PLATFORM | US | =/+ | | Strong consumer spending and labour markets will support overall demand, allowing us to believe that a recession is unlikely, while the economy should slow down towards potential growth. Our preference is for quality and non-cyclical value, while we are extremely cautious on non-profitable and expensive growth and the mega caps. |
| | US value | + | | The uncertainty around rising costs requires a focus on high-quality value companies that are less cyclical and that can deliver sustainable earnings growth. While the rotation favouring value may suffer near-term setbacks, the move towards these names is likely to continue in the long term. The key point here is prioritising selection over market directionality. |
| | US growth | - | | The long-term valuation of growth as a sector remains high, with wide dispersions. Repricing may in the technology sector may offer selective opportunities and we remain focused on long term earnings growth potential. |
| | Europe | -/= | | Higher stagflationary risks for Europe put pressure on earnings growth and may lead to further market repricing. Hence, we favour defensive name on one side, and high-quality cyclicals in industrials and materials on the other. |
| | Japan | = | | A mild deterioration in economic momentum leads us to remain vigilant on earnings. On the other hand, the JPY devaluation acts as a support for the market. Therefore, overall we maintain a neutral bias. |
| | China | = | | The zero Covid policy continues to weigh on the economic outlook for China, despite the additional recent stimulus. We see room for improvement in H2, along with the expected economic rebound. |
| | Emerging markets | = | | After the recent price actions, the EM equity space is becoming more attractive, but divergences are significant. We are positive on commodity exporters such as Brazil and UAE, and on domestic demand stories, but cautious on more expensive Asian countries. |
| FIXED INCOME PLATFORM | US govies | = | ▲ | Risks on nominal yields are both downward and upward as the higher inflationary environment comes with rising uncertainty on economic growth. Therefore our bias is towards neutrality now, with still some slight negative duration. Our exposure to TIPS is minimal. |
| | US IG corporate | =/+ | ▲ | After the recent spread widening, we are becoming more constructive on US IG on the basis of the solid macroeconomic backdrop in the US, positive corporate fundamentals (solid balance sheets with high liquidity levels and coverage ratios), the low risk of refinancing debt in the near term and the stable leverage. |
| | US HY corporate | = | | We remain neutral and selective in HY. On the one hand, the sector is supported by high energy prices, but on the other hand, valuations must be monitored, particularly as waning liquidity as a result of QT could tighten financial conditions. |
| | European govies | = | ▲ | While the long-term move towards higher core rates continues, geopolitical tensions and market stress are putting downward pressure on yields. This, coupled with the ECB's data-dependent approach wherein interest rates rise "some time" after the end of QE, underscores why investors should stay agile on duration. We are slightly less defensive (than before) on duration in core Europe less than before, as we are moving towards neutrality. |
| | Euro IG corporate | = | | In credit we prefer the high-grade space and short to medium maturities. We remain selective (corporate balance sheets are strong) due to high producer prices and potential pressures on margins. We think investors should consider moving from high-beta to low-beta segments/securities through a fundamental analysis-driven approach. |
| | Euro HY corporate | = | | Concerns around Europe's economic growth and inflation could weigh on corporate earnings, although spreads are lower than the levels seen in early March, indicating strong corporate fundamentals. Looking ahead, markets will distinguish credit on the basis of quality and liquidity risks, causing us to be very selective across the market. |
| | China govies | =/+ | | We maintain a slightly positive view on China government bonds as from a medium-term perspective, the asset class offers strong diversification benefits. |
| | EM bonds HC | + | | We are slightly constructive on EM bonds in HC, particularly on idiosyncratic stories that fit our strong bottom-up bias. Within this, we favour HY over IG on expectations of spread tightening in the former. |
| | EM bonds LC | = | | We remain constructive on EM duration in LC and believe there is scope for a reallocation towards commodity-exporting FX, even though we are slightly cautious on EM FX as a group. The high fragmentation in EM allows us to be very selective. |
| OTHER | Commodities | | | Commodities continue to be key assets for diversification and inflation protection. We are constructive on oil, owing to the tight supply (low capex over recent years) and inventories despite the continuing fall in demand. |
| | Currencies | | | The hawkish shift in communications from the ECB helped the EURUSD move away from the recent 20Y lows. While acknowledging that the end of negative rates may support the EUR in the medium term, we see the relative backdrop (growth and short-term rates) still favouring USD in the short term. |

**LEGEND**

--- -- - (Negative) = (Neutral) + ++ +++ (Positive) ▼ Downgrade vs previous month ▲ Upgraded vs previous month

Source: Amundi, as of 26 May 2022, views relative to a EUR-based investor. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This information should not be relied upon by the reader as research, investment advice or a recommendation regarding any fund or any security in particular. This information is strictly for illustrative and educational purposes and is subject to change. This information does not represent the actual current, past or future asset allocation or portfolio of any Amundi product. IG = investment grade corporate bonds, HY = high yield corporate, EM bonds HC/LC = EM bonds hard currency/local currency, WTI = West Texas Intermediate, QE = quantitative easing.

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# CROSS ASSET
## INVESTMENT STRATEGY

June 2022 #06




Document issued by Amundi Asset Management, "société par actions simplifiée"- SAS with a capital of €1,143,615,555 - Portfolio manager regulated by the AMF under number GP04000036 – Head office: 90-93 boulevard Pasteur – 75015 Paris – France – 437 574 452 RCS Paris – www.amundi.com

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